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International Economic & Energy Weekly

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Perspective

OPEC Awaits the Next Saudi Move 25X1

The inconclusive end to OPEC's meeting in Geneva this week points to a further erosion in oil prices. Without active Saudi cooperation, the organization will probably be unable to forge an approach to stabilize prices at its next meeting on 15 April. At this juncture the Saudis do not appear ready to help reverse the downward price path. Indeed, Saudi Arabia's strategy for capturing a greater market share has been successful so far. Demand is beginning to respond to lower prices and could register its largest annual increase since the late 1970s. Some high-cost oilfields—mainly in the United States—are also beginning to be shut in because of lower prices, a positive development in Riyadh's view. 25X1

The stakes of the Saudi strategy, however, are high. As Saudi output doubled, and Riyadh boosted sales through netback pricing, revenues for other producers have plummeted. Moreover, the new marketing approach carries a risk of reprisal from Iran and Libya that has caused uneasiness among Saudi Arabia's conservative Arab allies. 25X1

We believe a combination of objectives is probably behind Riyadh's strategy: increasing oil revenue; forcing producer cooperation on output to restore price stability and maintain current market share; ensuring a growing long-term market for oil; and, to a lesser extent, squeezing Iran economically. Domestic and international conditions cause one objective or another to dominate Saudi oil policy at any given time. For example, we believe that short-term revenue requirements were the driving force prompting Riyadh to abandon its OPEC role as swing producer. Each of these objectives entails different implications for the market and Saudi willingness to compromise within OPEC:

- Oil prices around $15 per barrel probably would satisfy Riyadh's revenue objective, in our view. If maintaining current revenues in the short run is Riyadh's prime objective, we would expect the Saudis to begin soon to take steps to stop the price decline.

- If Saudi Arabia wants to "teach other producers a lesson," it is probably prepared to see prices fall as low as $10 per barrel for several months.

- If a desire to ensure a growing long-term market dominates Saudi objectives, Riyadh will probably attempt to keep prices depressed for several years. Although it may not have a specific price objective, we believe the market response Riyadh would be seeking could be achieved in the $10 to $15 price range.

- Riyadh almost certainly is pleased that lower prices make financing the war effort more difficult for Iran. A shortfall in oil income, moreover, forces Tehran to cut domestic spending and limit imports of essential consumer goods, which probably would lead to an erosion in popular support for the Khomeini regime. 25X1

Although Riyadh may believe that it has the capacity to fine-tune the system, because of the complexity of the international oil market the Saudis might not be in a position to control a price collapse. Riyadh, in that event, would be blamed for precipitating a crisis and would face the risk of retaliation from other oil producers such as Iran and Libya, increasing the probability of a disruption of Persian Gulf oil supplies. 25X1

US vulnerability to future price shocks or supply disruptions is heightened considerably by any Saudi strategy promoting lower prices, regardless of the motive. Low oil prices discourage investment in exploration and development, especially in high-cost regions like the United States. Moreover, lower oil prices will encourage oil consumption and hasten a return to tight market conditions. Because of the high concentration of oil reserves in the volatile Middle East, lower oil prices will accelerate a return to greater dependence on this region. By the early 1990s, even a relatively minor disruption could produce another price shock. Since the Saudis hold the largest oil reserves in the area, Western dependence on Saudi Arabia as a major oil supplier would be increased, and Riyadh's political and economic clout would be enhanced.

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Iran-Iraq: Economic Situation Worsening 25X1

Declining oil prices and the falling dollar are compounding the problems facing Iran and Iraq from their ongoing conflict. Severe economic hardships in the months ahead will almost certainly increase the level of popular discontent in both countries. Neither Tehran nor Baghdad face economic collapse, however, and it would take several months before sustained economic strains would pose a serious threat to Iraqi President Saddam Husayn's grip on power or cause Iran to consider adopting a less aggressive stance on the war. 25X1

Iraqi Economic Outlook

Because of the sharp decline in oil prices, the Iraqi people face a severe decline in living standards in 1986. Assuming a $15 per barrel average oil price, we estimate Iraqi oil revenues will fall to about $8.5 billion this year from $11.4 billion in 1985. Moreover, the lower value of the US dollar increases the real impact because oil is priced in dollars, whereas most Iraqi imports and debts are valued in other currencies. If the dollar stabilizes at its current level, we estimate the impact would be equivalent to an additional 5-percent decline in revenues. In addition, oil exports, which represent 97 percent of foreign exchange earnings, are already at capacity.

Iraq is likely to reschedule approximately $1.5 billion in debt payments due this year, but is unlikely to obtain additional credit from its trade partners. We estimate Baghdad owes non-Arab creditors $9-10 billion. Western banks were reluctant to increase their exposure in Iraq even before the recent drop in oil prices and Iran's capture of Al Faw. The Embassy reports Baghdad also failed to obtain additional credits for imports of consumer goods from East European countries.

Baghdad can probably count on continued large-scale financial support from Saudi Arabia and

Iraq: Current Account, 1984-86 *Billion US $*

	1984	1985	1986 [a]	1986 [b]
Trade balance	−1.6	−0.7	−0.5	−3.6
Exports (f.o.b.)	10.7	11.7	8.8	8.8
Oil	10.4	11.4	8.5	8.5
Nonoil	0.3	0.3	0.3	0.3
Imports (c.i.f.)	12.3	12.4	9.3	12.4
Net services and private transfers	−2.8	−3.1	−3.4	− 3.4
Current account balance	**−4.4**	**−3.8**	**−3.9**	**− 7.0**

[a] Projection based on an average oil price of $15 per barrel, oil exports averaging 1.55 million b/d, and a 25-percent reduction in imports.
[b] Projection based on an average oil price of $15 per barrel, oil exports averaging 1.55 million b/d, and maintaining imports at the 1985 level.

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Kuwait, especially while Iran is doing well militarily. Riyadh and Kuwait have renewed an agreement to sell oil on Iraq's behalf, which brought in about $2 billion in 1985. In addition, Baghdad has probably received large cash infusions. Even with additional Arab aid, however, Baghdad cannot avoid substantial austerity measures. 25X1 25X1 25X1

New economic realities will force the Ba'thist regime to virtually abandon the domestic spending policies it has so far used to shore up political support. We estimate Iraq will need to cut imports by 25 to 30 percent. Most of the cuts will fall on remaining development projects and goods for domestic industry, creating shortages of nonessential consumer goods and fueling inflation. The US 25X1

Embassy already reports shortages of important domestically produced goods, and we foresee further reductions in the perquisites of military officers and public officials and in benefits to families of war dead. [redacted]

Heightened austerity will contribute to popular discontent and increase the likelihood of a coup within the Ba'th party. In particular, loss of perquisites and power as a result of lower oil revenues could encourage government officials and military officers—already upset by mismanagement of the war—to seek Saddam Husayn's removal. The greatest threat over the next several months, however, will be from Iran. A further deep incursion into Iraqi territory could push the army to stage a coup. [redacted]

Iran: Current Account, 1984-86 — *Billion US $*

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	1984	1985	1986 [a]	1986 [b]
Trade balance	−0.9	2.7	−0.6	−3.2
Exports (f.o.b.)	17.1	15.6	9.7	9.7
Oil	16.8	15.1	9.1	9.1
Nonoil	0.3	0.5	0.6	0.6
Imports (c.i.f.)	18.0	12.9	10.3	12.9
Net services and private transfers	−3.0	−2.8	−2.7	−2.7
Current account balance	**−3.9**	**−0.1**	**−3.3**	**−5.9**

[a] Projection based on an average oil price of $15 per barrel, oil exports averaging 1.66 million b/d, and a 20-percent reduction in imports.
[b] Projection based on an average oil price of $15 per barrel, oil exports averaging 1.66 million b/d, and maintaining imports at the 1985 level.

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[redacted]

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Iran's Economic Outlook

Iran has more options than Iraq in dealing with falling oil prices but lacks deep-pocketed allies like the Saudis. Oil accounts for only one-third of Iran's GDP compared with two-thirds for Iraq. Moreover, Tehran retains some $3-4 billion in liquid foreign exchange reserves and has negligible long-term foreign debts. [redacted]

Tehran's oil policy remains something of a wild card. Iran has the capacity to raise oil exports by up to 60 percent if Iraq does not destroy key oil facilities. Tehran has so far been unwilling to risk intensifying the current price war, in large part because the clerical regime believes that low oil prices only benefit the West. Nevertheless, Tehran's willingness to abide by its OPEC quota may fade if oil prices remain depressed over a long period. At the recently concluded OPEC meeting, Iran's Oil Minister threatened to greatly increase exports if OPEC cannot reach agreement on cutting production. [redacted]

Unless Iran increases oil exports, we estimate $15 a barrel oil and a weakened dollar would cause about a 35- to 40-percent decline in real foreign exchange earnings in 1986. [redacted] Iran expects to trim imports by at least 20 percent this year following a 30-percent reduction last year.

Iran could manage its finances with such a cut by accepting foreign credits, which it has so far avoided on ideological grounds. Tehran will probably avoid running down foreign exchange assets because it regards these as a cushion against an extreme emergency such as a complete cutoff of its oil exports [redacted]

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The war and slack oil market have caused Iran increasing economic distress, especially over the past year, and [redacted] growing resistance to calls for ever greater sacrifices. Food and military imports are likely to be spared in the next few months, leaving the full burden of cuts on the long-suffering industrial and construction sectors. Higher unemployment and inflation seem inevitable. Severe shortages of important consumer goods such as medicines and meat already exist, and most people must turn to the high-priced black market for their needs. On the plus side, domestic agricultural production is up and food shortages are unlikely. The government is also giving freer rein to the still important private sector, which should provide some cushion against necessary reductions in imports. [redacted]

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Recent military successes harden Tehran's will to fight on and help temper popular reaction to greater economic hardships. Moreover, the Islamic Republic retains considerable popular support. Economic problems are likely to produce some unrest, although not enough to pose a serious threat to the regime over the next 12 months unless combined with a major setback in the war. The need for even tougher austerity measures, however, may eventually convince Tehran that it must scale down its war effort to preserve the Islamic Republic and guarantee a tolerable level of long-run economic development. 25X1

Impact on the War

Financial constraints will not prevent either side from continuing the war in the short term. Iran's war effort is "labor-intensive," and the high level of Arab aid to Iraq almost guarantees that neither nation will find itself critically short of military supplies in the next several months. Over the longer term, however, Iran will probably find it difficult to maintain the scale of its military initiatives, and Iraq will need to trim plans to modernize its forces. 25X1

Both combatants presumably are reviewing their military options in light of current economic pressures. Iraq may mount more aggressive attacks on Iran's economic infrastructure. We believe Iraq has the capability to bring much of Iran's economy to a standstill by destroying its electrical system and oil refineries. If Baghdad maintains pressure on economic targets for a few months, Tehran might be compelled to accept a de facto truce in the war. Iran has warned Saudi Arabia and Kuwait to bolster the price of oil by restraining production and to discontinue their massive economic support for Iraq. Iran already appears to have stepped up attacks on tankers in the Gulf and will probably take stronger action—including terrorist acts or tanker seizures in the Gulf—if oil prices remain depressed. 25X1

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Mexico: Charting the Financial Gap [redacted] 25X1

Even though Mexican officials reduced their estimated financial gap from $9 billion in early February to $6 billion last week, we believe there still is a substantial gulf between Mexico's needs and the amount creditors are willing to offer. The de la Madrid administration has announced it will seek $2.5 billion in new commercial bank lending and another $1.5 billion in funding from multilateral lending institutions. [redacted] Mexican negotiators publicly claim the country will cover the remaining $2 billion through Paris Club reschedulings and bolstered nonoil exports, [redacted] foreign commercial banks plan to offer only $2.5 billion contingent on an agreement with the IMF and structural adjustment legislation. Perhaps more important, they have agreed to reject any Mexican request for interest payment concessions or capitalization. In addition to lost revenues, the banks fear a spillover of such concessions to other debtors. Moreover, banks do not want to appear to be rewarding Mexico for the country's poor economic policies in 1985. [redacted]

1986 Financing Gap—How Big?

From the perspective of foreign creditors and Washington, the first step in finding a solution to Mexico's financial problem lies in determining the true magnitude of the country's needs. To take a closer look at these needs, we have charted financing gaps under three scenarios. [redacted]

Sharing the Burden. In our view, the most probable outcome will be one of moderate sacrifice on the part of Mexico, with some sacrifice on the part of creditors. In this case, we project that GDP would decline about 3 percent and inflation would hit 80 to 85 percent. Under this scenario, Mexican oil prices stabilize at $15 per barrel and oil exports average 1.3 million b/d. In addition, LIBOR—the rate to which most Mexicans' loans are pegged—stays at about 8 percent. [redacted] 25X1

The nearly 50-percent fall in petroleum revenues projected for 1986 as a result of the price decline—about $6.5 billion—will be partially offset by at least a 20-percent increase in nonoil exports, made possible by stagnant domestic demand and a favorable exchange rate policy. Significant increases in maquiladora activity (assembly plants) fueled by aggressive support from Mexico City, the growing popularity of the program with US businessmen, and the higher expected level of US economic growth this year also could help rescue the current account. In our view, the country also can increase its tourism receipts 25 percent if it modestly devalues the peso and takes measures to allay tourists' safety concerns. [redacted] 25X1 25X1 25X1 25X1

Even though Mexico City soon will begin negotiations to join the GATT, import barriers probably will be retained through 1986. These restrictions, combined with a modest peso devaluation and depressed domestic demand, will keep imports well below 1985 levels. In addition, the country will save about $400 million from interest overpayments after last year's restructuring and perhaps that much again from lower priced imports of petroleum derivatives and petrochemicals. Therefore, we expect Mexico's import bill to decline by about $1.2 billion from the 1985 level. Even if de la Madrid is able to rebuild some confidence in the Mexican economy, the likelihood of depressed domestic interest rates and ineffectiveness of government attempts to repatriate capital will probably mean that capital flight will be reduced to $2.0 billion at best. Finally, we assume that the IMF will require as part of any 1986 financial package that the country raise foreign exchange reserves. [redacted] 25X1 25X1 25X1

Mexico: The Potential 1986 Financial Gap

Million US $

	1983	1984	1985 [a]	1986 [b]		
				Most Likely Case	No Adjust-ment	$10 per Barrel Oil Price
Current Account	5,324	3,969	−427	−2,497	−3,797	−3,370
Trade balance	13,762	12,800	8,235	4,318	3,168	3,445
Exports	22,312	24,054	21,835	16,718	16,268	14,745
Oil and products	16,017	16,602	14,675	8,018	8,018	5,445
Maquila	818	1,115	1,300	1,500	1,450	1,500
Other	5,477	6,297	5,860	7,200	6,800	7,800
Imports	8,551	11,254	13,600	12,400	13,100	11,300
Public sector	4,307	4,790	4,950	4,750	4,950	4,500
Private sector	4,244	6,465	8,650	7,650	8,150	6,800
Services balance	−8,437	−8,831	−8,662	−6,815	−6,965	−6,815
Of which:						
Interest payments	10,198	11,856	10,047	9,000	9,000	9,000
Tourism	1,183	1,307	1,200	1,500	1,350	1,500
Capital account	−1,106	−1,576	−1,931	4,998	6,798	5,870
Public sector	743	−207	519	7,178	8,978	8,050
Private sector	−1,849	−1,369	−2,450	−2,180	−2,180	−2,180
Change in reserves	3,301	2,241	−3,019	500	500	0
Errors and omissions and capital flight	917	151	3,000	2,000	2,500	2,500
Net borrowing needs [c]				**7,177**	**8,977**	**8,050**
Sources				6,300	4,800	6,300
Bank lending				2,500	1,000	2,500
Multilateral lending				1,600	1,600	1,600
Reschedulings				2,200	2,200	2,200
Banks				1,200	1,200	1,200
Paris Club				1,000	1,000	1,000
Financial gap				**877**	**4,177**	**1,750**

[a] Estimated.
[b] Projected.
[c] Including borrowing to finance the current account deficit, net private-sector borrowing needs, capital flight, and reserve changes.

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In our estimation, Mexico's financing needs would be about $7 billion under this scenario. As things now stand, the best Mexico City can hope for from commercial banks is a rescheduling of $1.2 billion in principal payments: $950 million originally due in 1985 but deferred until now because of last fall's earthquakes and another $250 million due this year. We do not believe banks will grant Mexico relief from interest payments or reduce their spread over LIBOR. The de la Madrid administration probably can negotiate a rescheduling of $1 billion in official amortization payments through the Paris Club. If new lending is limited to $4.1 billion—$2.5 billion from commercial banks and $1.6 from other sources—the country would face a financing shortfall of approximately $900 million, which could be managed through some combination of reserve drawdowns, additional import cuts, or appeals for foreign financing.

Limited Mexican Sacrifice. A less likely scenario could develop in which de la Madrid believes that, because of political constraints, he is unable to significantly improve the country's external balances through greater austerity. Lack of adjustment measures would limit the fall in real GDP to 1 or 2 percent, but the deterioration of Mexico's current account is substantial. In this case, we assume oil still is selling at $15 per barrel and that Mexico is exporting 1.3 million b/d. Once again, we assume LIBOR is at 8 percent. Unlike the first scenario, however, Mexico City does relatively little to offset lower oil prices.

Even with a less ambitious exchange rate policy, we assume the $6.5 billion loss in petroleum revenues is partially offset by an increase in nonoil exports of about 15 percent—about $1 billion, mainly the result of depressed domestic demand—and a 12-percent rise in tourism receipts. Growth of the maquiladora industry would be constrained by a lack of infrastructure investment and the politically motivated desire to rein in northern Mexican businessmen.

Lack of an aggressive exchange rate policy allows for only a modest saving in imports. Slow domestic demand reduces private-sector imports by $500 million, but the government's import bill is unchanged. Given the bleak economic future implied in this scenario, we assume capital flight reaches $2.5 billion. As before, we anticipate an IMF-recommended increase in foreign exchange reserves.

Under this scenario, we estimate Mexico would need $9 billion in external financing. Despite Mexico's unwillingness to take tough adjustment measures, we believe the country still can count on commercial banks to roll over both the $950 million principal payment from last year and the $250 million payment this year. The banks probably have already decided to reschedule these obligations to maintain the flow of interest payments. Similarly, a $1 billion Paris Club rescheduling is still likely. However, in light of the tough and united stance bankers now appear to be taking, we 25X1
would expect little in the way of new lending or concessions. At most, we believe foreign lending from all sources would total $2.6 billion. Without some relief from its creditors, the country almost certainly would be forced to withhold interest payments to cover the resulting $4 billion financing gap. 25X1

$10 Oil Prices. In the third scenario, the average price for Mexican oil falls to $10 per barrel and export volume of 1.3 million b/d is maintained. Again, LIBOR is at 8 percent. We believe the dramatic fall in revenues would prompt Mexico to adopt aggressive export promotion programs and 25X1
fairly strict import controls. At the same time, the country's creditors probably would be under even greater pressure to rethink their positions and adopt a concessionary stance. 25X1

We estimate that the $8.5 billion loss in crude oil revenues could be partially offset by a $2 billion increase in nonoil exports if Mexico City implemented a 20-percent devaluation and loosened some foreign investment laws. In addition, tourism receipts could be expected to climb 25 percent as 25X1
foreigners took advantage of the favorable peso/dollar rate. 25X1

The devaluation, import control, and lack of Mexican purchasing power also would save the country some $2 billion. We believe that nearly all of the savings would come from the private sector, which also carried the weight of adjustment when imports were slashed in 1983. 25X1 25X1

Action to bolster the country's external accounts would not come without high domestic costs, however. We estimate GDP would plunge 4 to 6 percent in real terms and inflation almost certainly would approach triple digits if Mexico City implemented these policies. These measures would be politically costly as well, especially in the north where trade is relatively more important and political dissatisfaction is highest. [redacted] 25X1

In this case, we estimate Mexico's borrowing needs would be slightly over $8 billion. We believe that Mexico's creditors, faced with the realities of $10 per barrel oil prices and encouraged by the de la Madrid administration's willingness to adjust, would be willing to grant some interest payment relief, in addition to rescheduling $1.2 billion in principal payments due this year. Thus, Mexico City might receive up to $6 billion in new lending, and an additional $1 billion in interest payment concessions. Despite this relief, however, we believe Mexico still would come up $1.75 billion short, forcing a further drawdown in reserves and interest payment arrearages. [redacted] 25X1

[redacted] 25X1

Summit Issues: The US Initiative on Debt 25X1

Both debtors and creditors have publicly welcomed the US initiative on global debt as a positive first step, but all groups have expressed some reservations. Big Six leaders consider the US initiative a good starting point for discussing debt and will probably make it a prominent issue at the Tokyo Summit. They might stress, however, that the approach needs rethinking, particularly in light of the impact of falling oil prices on oil-producing countries. Major debtor countries, meanwhile, are reluctant to undertake the substantial policy reforms that the approach entails, and some LDC leaders feel full subscription to the US plan is politically unpalatable at this time. Both debtor countries and commercial banks have publicly expressed some concerns with the US approach and responded with their own recommendations. 25X1

Debtors' Response

Summit participants will have an opportunity to gauge debtor attitudes at the IMF/IBRD committee meetings in April. The 11 Latin American nations of the Cartagena group [1] already have issued a set of "emergency" measures for negotiations on debt and growth that go beyond US recommendations. Meeting in Montevideo, Uruguay, on 16-17 December 1985, the foreign and finance ministers of the Cartagena group presented counterproposals to the US approach and stated in a joint declaration that structural problems in industrial countries—particularly high real interest rates—and falling terms of trade are the major obstacles to solving their debt problem. The ministers claim that living standards in Latin America have slipped to levels of a decade ago, and they argue that their countries cannot wait for improvements in the world economy.

The US Initiative on Debt

US Treasury Secretary James Baker proposed a new program for sustained growth in debtor countries on 8 October 1985 at the joint IMF/World Bank meeting in Seoul, South Korea:

- *Debtor countries are to adopt market-oriented policies to promote economic growth, hold down inflation, and shore up their balance of payments. These policies are aimed at improving the investment climate in these countries by allowing a larger role for private companies, asserting financial discipline over public enterprises, and eliminating a variety of economic controls.*

- *Lending by the World Bank and other multilateral development banks to countries that adopt such reforms would increase $9 billion over the next three years. The IMF also would play a central role in assisting and monitoring the adjustment process in debtor countries. The initiative foresees increased coordination between the World Bank and IMF to ensure consistent policy advice.*

- *Debtor countries that undertook market-oriented adjustment also would be eligible for $20 billion in new lending by commercial banks during the next three years. Secretary Baker has suggested that US banks put up $7 billion, with West European and Japanese banks providing the other $13 billion.* 25X1

Meanwhile, the group of 24 [2] (G-24) met on 4-6 March in Buenos Aires at the behest of Argentina 25X1

[1] The Cartagena group consists of Argentina, Bolivia, Brazil, Chile, Colombia, Dominican Republic, Ecuador, Mexico, Peru, Uruguay, and Venezuela.

[2] The G-24, formed at the 1972 Lima meeting of the G-77 to represent the interests of the Third World in international monetary affairs, consists of eight finance ministers each from Africa, Asia, and Latin America. 25X1

as the pro tempore chairman to try to reach a joint position on debt and related issues for the 9-10 April meeting of the IMF's Interim Committee. The G-24 report states that the US initiative contains some positive elements, such as the recognition that a lasting solution to the global debt problem requires sustained economic growth. However, the finance ministers believe the US initiative should be adapted to the needs of each country, providing resources necessary to offset the fall in the price of oil products and raw materials as well as the capital inflows necessary to achieve sustained economic growth. They declare that the repayment capacity of the debtors will improve only if the interest rates paid on their external debts are reduced to levels below the present market. 25X1

The declarations issued by the Cartagena group and the G-24 are part of the effort of Latin debtors to gain concessions from their international creditors. Latin leaders must try to appease growing domestic popular sentiment for a tougher stand with creditors. Moreover, they want Washington to view their debt problem as at least as important as issues in Central America. Finally, these countries are reluctant to undertake the substantial policy reforms that the US approach on debt entails because their leaders feel the reforms are politically unacceptable. 25X1

Creditor Banks and Western Government Responses

Private bankers and government officials in Western Europe and Japan remain skeptical about the US initiative despite their public support. The international banking community welcomed the initiative as a new and promising approach, but subsequently bankers have hedged their approval with several conditions. Some bankers now believe the amount of new lending envisioned in the initiative will need to be raised in view of the deterioration in oil producers' export earnings. West European bankers, in particular, want strong creditor government action before they make any commitments. British bankers, for instance, have said that they will not move forward on the US initiative without a go-ahead from the Bank of England. Senior managers of the 12 largest West German commercial banks claim that the initiative places too much of the burden on banks and have called for greater tax write offs on bad loans and more

The Cartagena Group Proposals on Debt and Growth

The Cartagena group presented nine items for negotiations on debt and growth at the Montevideo meeting including:

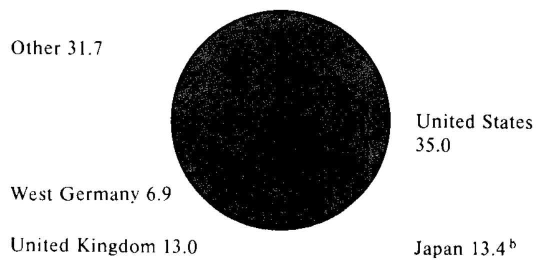
- *Western action to return real interest rates to historic levels and examination of mechanisms to ease the debt service burden.*
- *Increased capital flows to the region and a separation of old debt from new debt, with future credit flows getting lower rates.*
- *Increases in commercial bank lending to at least match world inflation.*
- *A limitation on debt payments, linked either to economic growth or to export earnings.*
- *A 20-percent annual increase in multilateral development lending for the next three years.*
- *Arrangement of multiyear restructuring and interest capitalization through the Paris Club, without creditors suspending new export credits or requiring an IMF-supported adjustment program.*
- *Enlarging and broadening the coverage of the IMF's compensatory financing facility to help offset the impact of deteriorating terms of trade, natural disasters, and increased interest rates.*
- *An easing of conditionality required by creditors for new loans to allow for economic growth.*
- *Elimination of industrial country protectionist measures.*

In addition to these proposals, the Cartagena Steering Committee, which met on 27-28 February in Punta del Este, Uruguay, to respond to the "emergency" situation created by the drop in oil prices, voiced full support for Cartagena members' efforts to modify existing debt agreements, especially by renegotiating interest rates. 25X1

Commercial Bank Exposure to 15 Troubled Debtors[a]

Percent

Total: $273 billion



[a] Data are for December 1984. The 15 countries are Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Ivory Coast, Mexico, Morocco, Nigeria, Peru, Philippines, Uruguay, Venezuela, and Yugoslavia.

[b] Venezuelan debt to Japanese banks not available.

[redacted]

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export credit guarantees. [redacted]

[redacted]

Governments' reaction has been generally favorable:

- ***Japan***'s Finance Ministry already has called on its banks to contribute $3 billion and advocates implementing the initiative on a case-by-case basis.

- ***French*** Finance Minister Beregovoy has praised the US initiative as a "big step forward," and French officials are especially pleased with its proposals for a cooperative creditor strategy and an enhanced role for the World Bank.

- ***British*** officials agree with the objectives and concept of the approach but believe that "substantial" changes are needed to get both lenders and borrowers alike on board.

- ***Italian*** officials see no alternative to increased lending while the ***Canadians*** believe they have a lot at stake because of Canadian exposure in Latin America.

[redacted] 25X1

EC Finance Ministers will try to formulate a coordinated position on the US initiative when they meet in the Netherlands on 4-6 April. [redacted] 25X1

Even if bankers and government officials go along with the US concept, they are likely to insist that US banks take on a larger share of the lending. [redacted] many West European banks are not willing to put up substantial new funds for debtor countries such as Mexico. Despite the exposure of their banks, the governments and private banks in Western Europe and Japan believe the burden of dealing with the problems falls on Washington because they view Mexico primarily as a US responsibility. Although they could suffer financial losses, they are in much better shape than most major US banks because of greater reserves against their troubled loans and more favorable writeoffs for bad debts. [redacted] 25X1 25X1 25X1 25X1 25X1

Implementation of US Strategy

Some financial observers are concerned that if the US approach is not soon translated into a workable plan for major debtors such as Mexico, Argentina, and the Philippines, the initiative may wither on the vine. Thus far, however, most debtors have displayed little commitment to economic policy reforms. Creditor banks also want to see the US concept turned into reality but will be hesitant to become the sole source of additional funds. Bankers believe that more leadership is required from Western governments to implement the US approach.

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Because of the serious global debt situation, Big Six leaders undoubtedly will be eager to discuss the international debt situation at the Tokyo Summit. The United Kingdom, for example, regards it as a "high stakes" issue because of London's status as a key financial center. West German Finance Minister Stoltenberg has suggested making it the main theme of the summit. The Big Six countries are likely to declare publicly support for the US initiative; they are unlikely, however, to agree to boost export credits substantially or make the regulatory changes that their bankers want.

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Summit Issues: The New GATT Round [redacted] 25X1

Big Six leaders will probably not make the launching of a new round of multilateral trade negotiations a major issue at the Tokyo Summit. Disagreement on some aspects of the trade talks could arise, however, particularly regarding agriculture, Japanese trade practices, investment, and textiles. Non-US participants will probably seek a general endorsement for the new round in order to keep preparations on track and thus help avoid fueling US protectionist pressures. Japan will probably try to use statements of support for the new round to help deflect attention from its contentious bilateral trade issues. [redacted]

New Round Status

All summit partners have expressed general support for the launching of a new trade round at the GATT Ministerial in September. The Big Six have also endorsed the inclusion of trade in services in the GATT negotiations, a key US initiative. Nonetheless, many major issues for the new round's agenda are still unresolved. [redacted]

A principal source of contention is the inclusion of new trade issues. Several LDCs, led by India and Brazil, have been arguing that the GATT is not the proper forum for negotiating rules to promote liberalized trade in services, enforcement of intellectual property rights, and less restricted foreign investment—key new round initiatives of the United States. A longstanding demand by many LDCs—including newly industrialized countries (NICs)—is either that they be exempt from new GATT agreements or that the agreements be applied to LDCs gradually, given their special need to protect domestic markets. Many LDCs are also insisting that industrial country reduction of trade barriers against traditional LDC exports, such as agricultural products and textiles, be accomplished as "confidence building" measures before a new round begins. The West Europeans, however, are likely to balk at LDC proposals—particularly on textiles—which threaten to increase European unemployment. Moreover, disagreement also exists among the industrialized countries on a number of these issues. [redacted] 25X1

At the Summit

Agriculture has the potential to be the most contentious GATT-related issue at the summit. The EC has repeatedly warned that proposals aimed at attacking its Common Agricultural Policy (CAP) are not negotiable. 25X1 France, the most zealous defender of the CAP, believes that any GATT discussion of agriculture will degenerate into an attack on EC policy. The conservative victory in last week's French parliamentary elections, moreover, probably presages an even tougher stance by Paris. French President Mitterrand cited this concern in opposing the Bonn Summit's declaration of support for the new round last year. 25X1 Jacques Chirac, the new prime minister, has expressed opposition to a new trade round unless EC-US differences on agriculture are resolved, according to Embassy reporting. Among other summit countries:

- We believe that **Italy** would support French opposition to agriculture's inclusion in the GATT.
- The **United Kingdom,** on the other hand, has stated that agriculture is a priority issue for the trade round.
- **West Germany,** while backing London, is unlikely to press the issue in Tokyo, since its farmers are heavily dependent on CAP subsidies and Chancellor Kohl probably is unwilling to antagonize the French over this issue.

- **Canada,** although unlikely to initiate discussion of agriculture issues, is strongly opposed to EC agricultural subsidies and to recently enacted US farm legislation. [redacted]

Japanese trade restrictions are likely to become the target of a West European attack. The EC has long viewed Japan as the most notorious unfair player within the GATT, and last week proposed discussing that problem formally in the new round. Although Japan will attempt to steer summit deliberations away from the market access issue, the Europeans will probably attempt to use Tokyo's desire as summit host to avoid major blowups as a means to gain Japanese concessions in this area. [redacted]

Textiles has the potential to become a problem issue. Although EC trade ministers recently agreed that current negotiations to renew the Multifiber Arrangement (MFA) should be followed by efforts in the new round to liberalize trade in textiles and apparel trade, individual EC members are probably still divided on the question. France and Italy, in fact, are seeking a more restrictive extension of the MFA to protect their textile and apparel industries from LDC exports. Bonn and London, in contrast, believe the industrial countries can solidify LDC support for the trade round by phasing out the MFA and including textiles in the GATT negotiations. Canada will probably oppose folding MFA into the GATT. [redacted]

Trade-related investment could also generate disagreement at the summit. London, Bonn, and Rome believe that the current US position on including investment in the new round is too broad and is being pressed too hard. In their view, according to US Embassy reporting, the United States risks provoking strong LDC resistance not only to including investment but also to other GATT priorities, such as services. The three countries believe the LDCs will particularly oppose investment if topics such as expropriation are included. They prefer to restrict GATT negotiations to areas the LDCs will probably find less sensitive, such as investment incentives, export performance requirements, and local content. Japanese officials similarly are hesitant about making the discussion of investment too broad, according to Embassy reporting. [redacted] 25X1

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Intellectual property rights may receive only lukewarm response from several non-US participants. According to US Embassy reporting, the United Kingdom, West Germany, and Italy view the issue with little enthusiasm. Bonn, for example, believes that pushing too hard on copyright violations and counterfeit goods, in which LDCs are major offenders, could reduce LDC support for the new round. [redacted] 25X1

Services will probably not prompt serious disagreement at the summit. Once the new round begins, considerable disagreement will probably emerge regarding specific service sectors to be included and the means for negotiating service trade rules. [redacted] 25X1

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Beyond the Summit

Although the summit almost certainly will support the launching of the new round, substantial disagreement on key topics has the potential for slowing the progress of the new round. Open discord among the summit participants—such as an EC attack on Japanese trade restrictions—would diminish developed country unity on the new round and could cause problems for US efforts to include some items on the new round's agenda. [redacted] 25X1

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[redacted] 25X1

US Sanctions Against Libya: Opportunities for Eastern Europe

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US sanctions against Libya may provide an opportunity for Eastern Europe to earn badly needed hard currency as well as to diversify its sources of oil. Several East European countries—particularly Bulgaria, Romania, and Hungary—may seek to supply Libya with technology and petroleum drilling equipment previously supplied by US firms. Bloc countries almost certainly must weigh carefully Tripoli's past unreliability in paying many of its East European suppliers. Moreover, Eastern Europe's potential to capitalize on the sanctions depends on West European competition because Libya, for both economic and political reasons, is likely to view the Bloc as a second choice. 25X1

Turning Oil Into Hard Currency

A substantial portion of the Libyan crude oil obtained in barter deals is refined and reexported to the West for hard currency.[1] From 1980 to 1985 the region earned $4-7 billion in hard currency annually from reexports of oil. Over the past decade Libya has provided 13 to 15 percent of Eastern Europe's non-Soviet oil imports. In 1983 Bulgaria and Hungary relied the most on Libyan oil, importing over 75 percent of their non-Soviet oil from Libya. Poland (60 percent of non-Soviet oil imports), Yugoslavia (30 percent), and Romania (10 percent) also counted on Libyan oil. According to the US Embassy in Prague, Czechoslovakia has received substantial amounts of Libyan oil, which it has resold on the spot market, although neither country reports these deals. East Germany imports little, if any, oil from Libya. 25X1

Commercial Ties Limited

Although Libya has played a relatively small role in Eastern Europe's foreign trade, the growth in Eastern Europe's exports to Libya since 1980—almost 2 percent annually—exceeds the growth of the region's exports to developing countries as a whole. In 1984 Libya purchased 10 percent of the region's hard currency exports to developing countries. Hungary and Bulgaria have seen the most rapid growth of exports to Libya; East Germany has experienced a decline in sales. 25X1

Libya provides an outlet for East European arms and manufactured goods, many of which are not competitive in Western markets. Czechoslovakia, Yugoslavia, and Bulgaria have been Libya's major East European arms suppliers. In 1983 and 1984 East European arms deliveries to Libya totaled $480 million and $350 million, respectively. Eastern Europe also supplies services and equipment for oil drilling and refining and constructs large-scale projects such as refineries, factories, power plants, irrigation systems, agricultural facilities, housing, roads, and some military-related projects. Because of the scarcity of skilled professionals and need for construction crews, Tripoli employs a sizable number of East European guest workers and pays their salaries in hard currency. An estimated 50,000 East Europeans—including 800 military advisers—currently work in Libya. 25X1

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Opportunities for Expanded Ties

East European firms potentially could fill some of the gaps left as US firms comply with the sanctions. Bulgaria and Romania already have an established presence in Libya as suppliers of petroleum drilling and exploration equipment and technicians. These countries probably could provide additional equipment and services of sufficient

[1] The USSR supplies about 70 percent of Eastern Europe's oil imports and Libya, along with Iran and Iraq, supplies the rest.

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quality and quantity to maintain Libyan oil production and exports. Tripoli is already hiring Bulgarian crews to replace US crews in conducting seismic studies and is likely to bring in more Bulgarian crews as needed.

Incentives for East European countries to replace US firms in Libya include:

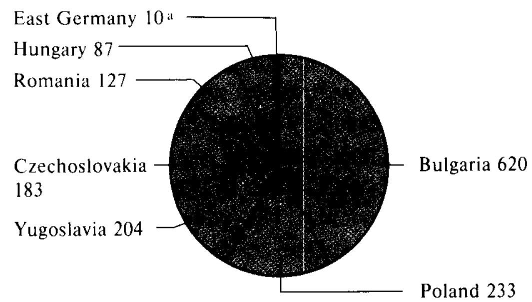
- ***Hard currency earnings.*** Increased sales of equipment and services to Libya, specifically in the petroleum sector, could generate hard currency—either by direct payment or via reexport of more Libyan oil. Goods and services previously supplied by US firms totaled about $600-700 million annually. Because of the soft oil market, Eastern Europe may have good bargaining leverage in striking barter deals with Libya. These same market conditions, however, limit prospects for reexporting more of this oil without putting additional pressure on prices. Still, even if Eastern Europe marketed just one-fourth of the Libyan oil formerly sold by US companies and prices plunged to $10 per barrel, the region could earn annually nearly $200 million in hard currency.

- ***Diversification of Oil Sources.*** By diversifying its energy sources, Eastern Europe lowers the risk of domestic energy shortfalls—a particular concern if the Soviets decrease their oil exports to the region. The USSR might choose to redirect some oil exports to the West to generate hard currency in the wake of falling energy prices or retain more oil at home to balance supplies with growing domestic demand. In addition, Eastern Europe may look increasingly to Third World oil producers such as Libya because the price for Soviet oil—while payable in East European goods—is now almost twice the world price.

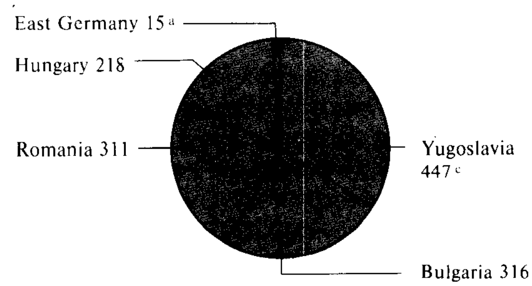
Eastern Europe: Trade With Libya, 1984

Million US $

Exports to Libya



Imports From Libya[b]



[a] Estimated.

[b] According to official East European trade statistics, Czechoslovakian and Polish imports of Libyan goods are negligible.

[c] Including some oil imports on Soviet accounts.

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The Risks

Eastern Europe is probably approaching increased Libyan commercial ties with caution. In recent years several Bloc countries have encountered difficulty in receiving payment for exports—including military hardware—and construction services. Falling oil prices and revenues have worsened Tripoli's cash flow problems. Uncertainty about Libya's creditworthiness has probably limited trade between Tripoli and the Bloc.

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Libya's cash shortage has forced some of its East European creditors to accept payment in oil, and even then Tripoli has been less than reliable in making deliveries. [redacted] some East European firms have had considerable difficulty getting Libya to deliver oil to settle debts. Recently, Romania blamed its inability to meet payments due to Western banks on Libya's failure to meet its commitment to deliver oil for resale. Even if this accusation is exaggerated, such bad experiences may induce Romania and other Bloc countries to go slowly on expanding trade ties. [redacted]

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Outlook

Despite the risks, East European countries are likely to try to supply Libya with goods and services previously furnished by US firms. However, the region's ability to do so is limited. Soviet demands for oil and gas equipment, coupled with its hard currency shortages, could persuade the USSR to look to its East European allies to replace Western equipment purchases. The need to supply the Soviet economy could leave little slack capacity to produce goods for the Libyans. [redacted] 25X1

Furthermore, competition from West European and Asian firms also seeking to benefit from US sanctions will limit the Bloc's gains. [redacted] 25X1

[redacted] 25X1

Libyan authorities are likely to continue to favor these firms over the East Europeans. By employing Western firms, Qadhafi would not only receive better quality goods and services but also isolate the United States from its West European allies. As long as Eastern Europe faces such competition, its gains from increased commercial ties to Libya will be restricted. [redacted] 25X1

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[redacted] 25X1

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The USSR and China: Boosting Industrial Use of Computers 25X1

The Soviet Union and China have each embarked on ambitious programs to bolster labor productivity, raise product quality, and improve management practices by introducing more low- and intermediate-level computer technology throughout their economies. In our judgment, because it has easier access to Western equipment and technical support and less resistance to computer use, China will achieve more rapid short-term progress in the widespread introduction of computers in industrial facilities, but both countries will remain behind the West. Potentially, the efforts to introduce computer technology into Soviet and Chinese industry will create new market opportunities in Western firms, but will heighten tensions among COCOM members. As China's own computer production capability and imports rise, moreover, China could become a new target for Soviet computer-related acquisitions.

Lagging Behind the West

Soviet and Chinese enterprises lag behind Western enterprises in exploiting electronic technology to boost productivity and raise product quality. One knowledgeable American academic has estimated that less than 8 percent of Soviet industrial enterprises had mainframes in 1984. China has far fewer mainframes than the Soviet Union—probably less than 1 percent of China's factories had either minicomputers or mainframes by the end of 1984. Moreover, the Soviets and Chinese both have difficulty applying existing computer technology. The Chinese admit to having 70,000 microcomputers idle in warehouses, and to using 50 to 80 percent of their computers ineffectively. Soviet officials have also openly complained that computers are not used efficiently. Nationwide statistics on computer utilization are not available, but a recent Soviet press report acknowledged that in Leningrad, on average, only 60 to 70 percent of the capacity of automation facilities and computers is being used.

Ambitious Goals . . .

Both the Soviets and the Chinese have ambitious goals for the widespread application of computers at factories and research institutes. In January 1985, the Soviet Politburo approved a program for the development, production, and effective use of computer technology and automated systems up to the year 2000. An important part of this effort is a plan to put as many as 1 million personal computers in secondary and vocational-technical schools over the next 15 years. China is also embarking on an ambitious program to broaden the use of computers throughout the economy. A number of ministries and central agencies, spurred on both by the economic modernization strategy and by the US and COCOM adoption of more liberal export control policies toward China, have undertaken programs to apply computer technology to production and planning. 25X1 25X1

. . . But Different Approaches

The Soviets, confronted with stronger Western export controls, are being forced to rely more on domestic and CEMA resources to increase the availability of computers. Soviet efforts to obtain Western turnkey facilities and process technology for the manufacture of computer equipment have been consistently rebuffed. The draft 12th Five-Year Plan (1986-90) calls for an increase in overall computer production of 100 to 130 percent and the start of mass production of PCs. Although the Soviets currently have a much more developed computer industry than the Chinese—at least for the larger minicomputer and mainframe systems—production problems, especially in the microelectronics and magnetic disk drive areas, have consistently frustrated Soviet efforts to increase computer output. 25X1

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China has used its advantage of a more liberal Western export control policy to import large amounts of computers and computer equipment. We estimate that China in 1985 imported 65,000 microcomputers from the West compared with less than 10,000 for the Soviets. The Chinese also have a headstart on the Soviets in the application of personal computers, acknowledged in both countries as one of the key components in raising industrial efficiency and spurring innovation. Since the beginning of 1983, when the government announced a decision to focus on minicomputers, China has purchased over 125,000 PCs from the West. Although China has recently cut back on purchases of Western PCs, this has been partially offset by increased domestic production, primarily through the assembly of imported computer kits. [redacted]

Computers in China and the USSR, 1985 [a] — *Number of units* (except where noted)

	China	USSR
Stocks	200,000	66,000
Microcomputers	190,000	6,000
Minicomputers/ mainframes	10,000	60,000
Domestic output	32,000	5,000 to 7,500
Microcomputers	30,000	1,000
Minicomputers/ mainframes	2,000	4,000 to 6,500
Imports		
Units	65,000	4,000 to 5,000
Value (*million US $*)	328	NA

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[a] Estimated. Reliable statistics on the Soviet and Chinese computer sectors are scarce. Our estimates are drawn from Chinese and Soviet statements and analysis of trade data.

[redacted] 25X1

Odds Favor Greater Chinese Progress . . .

Domestic Opposition. The Soviets have to deal with opposition from party and police officials, who view the widespread use of computers as a threat to the state monopoly of information. The prospect of millions of personal computers—each a potential printing press when coupled with a printer and wordprocessing software—alarms the leadership. In contrast, [redacted] the Chinese seem to have fewer ideological inhibitions against broad dissemination of information. [redacted]

Chinese managers generally need less persuasion than their Soviet counterparts to adopt computer technology. Incentives to improve profitability by cutting waste, reducing production costs, and increasing output are built into China's economic reform program—and many managers have sought computers to improve industrial performance. In contrast, Soviet managers often are reluctant to incorporate new technologies that could temporarily lower output. Moreover, bonuses are often tied to the number of computer tasks performed and to the number of subsystems in place. So, instead of developing integrated systems, users create many separate—cumulatively inefficient—systems. [redacted]

Yet another barrier for Moscow is resistance from Soviet industrialists and scientists to the use of imported equipment or production lines to meet demand while the domestic computer industry gears up. Our statistics on Soviet computer imports are incomplete, but we believe that the vast majority of the computers in the Soviet Union were manufactured domestically. The fear is that massive imports will undermine commitment to domestic development of computer technology. Beijing has also grown protective of its infant computer industry in the last few months. Even so, Beijing acknowledges the need for imports—of microcomputer kits, or finished minicomputers and mainframes, if not of completed micros. We estimate that since the start of 1983 imports have accounted for roughly two-thirds of China's microcomputer inventory. [redacted]

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Greater Access to Foreign Technology and Training. China enjoys greater access to Western computers, production technology, training, and after sales support than the Soviet Union. COCOM relaxed restrictions on sales of eight-bit computers—the type sought for school use—to the Soviet

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Union in January 1985, but controls on sales of more sophisticated 16-bit computers required for Soviet industrial, scientific, and higher education applications remain stringent. For China, US export licenses for most 16-bit microcomputers have routinely been approved since November 1983; US firms have been able to get bulk distribution licenses for them for more than a year. Although the licensing process is lengthier for minicomputers and mainframes, most are also approved by the United States and COCOM for sale to China. Beijing also faces fewer obstacles to the transfer of computer production know-how. China is currently pursuing more than 100 cooperative projects for computer or peripheral production with foreign firms—mostly US—and last year signed its first joint venture agreement to coproduce mainframes. US and COCOM guidelines strictly embargo transfers of computer production technology to the Soviet Union.

China also benefits from the overseas training available to students, engineers, and technicians. Our records are spotty, but nonetheless show a clear trend: between 1979 and 1985, the United States hosted thousands of Chinese students and trainees in computer-related fields, according to information supplied on visa applications. The Soviets have, by and large, sent students and engineers to East European countries, where the level of technology and quality of instruction is generally inferior.

... But Both Will Remain Behind the West

Nonetheless, we believe both the Soviet Union and China will for many years remain far behind the West in effectively assimilating computer technology into their economies. One obstacle both countries face is the poor internal coordination of plans for the computer industry. In the Soviet Union, four ministries are producing computer hardware and nearly 30 ministries are involved in the development of software. To overcome this problem, the Soviet Politburo in March 1986 adopted a decision calling for an all-union state committee for computer technology and information science, which would be responsible for coordinating all projects involved in the development, manufacture, use, and servicing of computers. Beijing formed just such an oversight agency in 1982, but dozens of agencies that import or use computers are still not represented on the body. In both countries, the absence of strong central coordination will impede progress in adopting national standards for computer equipment and software. 25X1

Although US and COCOM controls over sales of Western computer equipment will have a greater impact on the Soviet computerization effort, export controls will also frustrate China's attempts to broaden computer use. Controls on sales of mainframe computers, advanced software, networking equipment, and telecommunications gear will restrict China's use of computers in some areas, including robotics, microcircuit design, seismic 25X1
data processing, weather forecasting, and intercity computer networking. 25X1

Inadequate support also will continue to impair both countries' efforts to use their computers effectively. In China, as in the USSR, shortages of key technical personnel will not be quickly remedied. Both countries have only a fraction of the number of programers, repairmen, educators, and other technical support personnel available in the United States.[1] We expect Beijing will be slow to implement its ambitious plans for a tenfold increase in the number of software writers by 1990 and a similar jump in the number of service personnel. 25X1
Moscow's plans, far less well defined, will probably take even longer before yielding significant results. In addition unreliable electric power systems cause frequent computer crashes and damage to equipment, and erratic telecommunications links prevent local or wide area computer networking. 25X1

Finally, Soviet and Chinese users both have to find ways to communicate with their computers in Russian or Chinese—languages for which little computer software and hardware have been developed. Neither country can hope to make computer use widespread if users must know English or

[1] Estimates place the US figure near 500,000, the Chinese number at roughly 18,000. Comparable statistics for the Soviets are not available, but shortages of software and service personnel have been widely reported. 25X1

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Japanese as a prerequisite. Off-the-shelf software packages to handle routine tasks, readily available in the West, must also be adapted to Russian or Chinese—and often completely rewritten to accommodate unique Soviet or Chinese inventory or accounting practices as well. [redacted]

The United States Will Face New Export Control Issues

We expect the demand for computers generated by the Soviet and Chinese industrial modernization efforts to generate new frictions among COCOM allies over export control issues. European COCOM members may be more eager than the United States to permit the sale of computer equipment and production lines to the Soviet Union—where their firms have established commercial ties—and less so to China, where US firms have taken the lead. Although turnkey computer factory transfers to the USSR are currently prohibited by US and COCOM regulations, West European vendors are particularly interested in such sales. Moreover, as China grows increasingly interested in acquiring networking equipment, advanced software, supercomputers, and production technology for minicomputers and mainframes, COCOM differences will crop up with greater frequency in these areas as well. Washington will be the primary target of COCOM frustrations, in our view, because US sales will generate the vast majority of the controversial cases; US firms not only are China's major source of supply for large computers, they also are likely to be more willing than their competitors to transfer production technology. [redacted]

The development of China's computer industry could also create additional export control issues for the United States and COCOM in the future. China's industry is advancing most rapidly in an area where the Soviets are particularly weak—personal computer technology. As a result, China could become a target for Soviet attempts to acquire microcomputer and peripheral equipment.

We believe a Chinese decision to sell the Soviets computer equipment is unlikely as long as Beijing views Moscow as a strategic threat and believes such sales would contribute to Soviet military strength. But because individual Chinese factories are encouraged to boost profits and foreign exchange earnings—and are periodically granted autonomy to conduct their own foreign trade—such sales could occur outside of Beijing's control. For example, [redacted] during a period of decentralized trade control last year, the Soviets purchased 1,000 16-bit PCs—IBM PC/XTs or PC/XT copies. In the future, Chinese exports to nonaligned developing countries—an attractive market for a new entrant to the electronics trade—could also find their way to the Soviet Union without Beijing's complicity and without COCOM approval. [redacted]

[redacted]

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Briefs

Energy

Shakeup Pending in Indonesia's Oil Industry

[redacted]

Rumors are circulating in Jakarta of a wholesale shakeup at Pertamina—the state oil monopoly—when the five-year term of the board of directors expires at the end of March, according to the US Embassy. President Director Ramly, who replaced the discredited Joedo Sumbono in 1984, is among those rumored to be getting the ax. There are also hints of a reorganization at the Department of Mines and Energy, including the creation of two junior ministerial positions—one for oil and one for oil marketing—Ramly will reportedly be the junior Minister for Oil. The rumor that Ramly may be on his way out is particularly disquieting since he has the confidence of foreign oil companies. Replacing him with an unknown when oil prices have collapsed and Indonesia is experiencing difficulty marketing its crude oil abroad could create some friction until the new director and the companies establish a working relationship. [redacted]

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Indonesia Rescinds Official Crude Oil Selling Price

[redacted]

According to a US Embassy report, the government in late February abandoned the use of the official price for crude oil as a reference for assessing foreign oil companies' tax liability and cost reimbursements. This decision effectively reestablished the 85/15-percent split between the government and production sharing contractors and clears the way for them to maximize oil production as requested by Jakarta. The government has been anxious to boost output to offset declining prices. Jakarta's adherence to an unrealistically high official price, however, had effectively reduced the split to an estimated 90 to 95 percent for Jakarta and 10 to 5 percent for the oil companies. As a result, foreign oil companies were reluctant to increase output. [redacted]

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Financing Venezuela's Joint Oil Ventures

[redacted]

Press reports indicate that PDVSA, the state oil monopoly, continues to seek joint ventures abroad to secure a captive export market for 800,000 b/d of crude and refined products—more than half PDVSA's planned exports. The strategy is to acquire up to 50-percent equity in existing refining and distribution facilities, while leaving operating authority with the foreign partner. Last month Caracas announced deals that will soon bring exports to such captive clients abroad to about 440,000 b/d. Negotiations with British Petroleum, Exxon, and Champlin Petroleum—and reported interest in at least three additional facilities—would push the total over the 800,000 b/d mark. [redacted] Such acquisitions were to have been financed out of PDVSA's investment reserve, but this fund may be used instead by the central government to cover a looming budgetary deficit. In that case, acquisitions would be difficult to finance unless joint venture partners accepted payment in petroleum. [redacted]

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[redacted] 25X1

Jordanian Oil Exploration Agreement Signed

[redacted]

According to press reports, Jordan signed a profit-sharing agreement with the US firm Amoco last week. Under terms of the agreement, Amoco will search for oil in the Jordan Valley and Al-Azraq regions. The agreement extends for seven and a half years, with the company obligated to conduct extensive field studies of the exploration areas. Amoco will drill at least five exploratory wells. [redacted] 25X1 25X1

Yugoslavia Seeks Lower Oil Import Prices

[redacted]

Yugoslavia has negotiated lower oil import prices with its Middle Eastern suppliers and with the Soviet Union, which normally supplies about 50 percent of the country's oil imports. According to the US Embassy in Belgrade, import prices for March delivery have reportedly been reduced on average by 26 percent, and new prices are to be negotiated following this week's OPEC meetings. If the lower prices remain in force and Yugoslavia imports the planned 217,000 b/d in 1986, Belgrade's oil import bill would be cut by at least $500 million. While falling oil prices are good news, the benefits will not be as large as the price reductions suggest. Hard currency savings will be much less because the bulk of Yugoslavia's oil imports are barter trade or clearing account deals. Although energy-dependent industries will benefit, enterprises that depend heavily on exports of goods and services to the Middle East or the Soviet Union may lose sales, and may be unable to redirect their low-quality exports to Western markets. [redacted] 25X1 25X1

Egypt's Nuclear Power Option

[redacted]

The Egyptian Government appears determined to keep alive its plans for civil nuclear power, despite continuing economic difficulties. President Mubarak led cabinet reviews in January that reaffirmed the importance of nuclear power for future electricity generation, according to the US Embassy. Nuclear power had been questioned in light of the deteriorating economy, a World Bank recommendation that coal would be a more cost-effective energy source, and concerns about the safety of nuclear energy. The Egyptians are having difficulty financing the ambitious El Dabaa nuclear power project—the centerpiece of their immediate nuclear plans, and austerity measures cloud the short-term prospects for nuclear power in Egypt. The Embassy reports that Mubarak will postpone any decision on the El Dabaa contract pending the outcome of the government study. [redacted] 25X1 25X1

International Finance

South African Rescheduling Moves Forward

[redacted]

South Africa and its commercial bank creditors have agreed to modify the compromise debt accord suggested last month by Swiss debt mediator Fritz Leutwiler, extending the deferral of principal repayments from 12 to 15 months. The agreement—negotiated by 12 key creditor banks—still requires the cooperation of some 200 smaller creditors. Under the new plan, Pretoria's unilateral freeze of $14 billion of its $24 billion in foreign debts would be replaced on 1 April by a tacit agreement by banks to roll over 95 percent of the currently frozen loans through June 1987. Pretoria is to repay the other 5 percent on the original maturity dates during this extension. In addition, a 5-percent downpayment on the arrearages accumulated during Pretoria's unilateral freeze would be paid on 15 April. Creditor banks plan to review the South African situation in April 1987. [redacted] many banks hope to replace the current arrangement with a 5-to-7-year rescheduling agreement at that time. If black unrest persists during the coming year, however—which we consider likely—creditors may again resort to a short debt deferral to maintain the appearance of pressuring Pretoria. [redacted]

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New Moroccan Rescheduling Talks

[redacted]

The initial meeting at mid-month on rescheduling Morocco's 1985-86 commercial debt payments produced few results. Stumblingblocks were financing short-term debt, provision of new loans, and medium-term debt rescheduling terms. Rabat is pressing to convert about half of its $400 million in short-term debt into medium-term debt to be included in the rescheduling. Morocco is also asking for $200 million in new money. The banks are pushing for relatively tough rescheduling terms: a repayment period of 10 years with five years' grace at an interest rate 1.125 percentage points above LIBOR. Talks are slated to resume on 10 April, but could be contentious. Morocco's 1983-84 rescheduling was nearly derailed earlier this year by Rabat's failure to live up to the terms of the accord. [redacted]

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Tunisia Borrows Again

[redacted]

Tunisia's growing foreign exchange gap has pushed the government to secure a $175 million Eurodollar loan, the first borrowing in 18 months. Nonetheless, the loan terms—0.5 to 0.63 percentage point over LIBOR—do not show lender apprehension over Tunisia's creditworthiness. The new loan probably will be insufficient to cover the projected financial gap caused by low oil prices and drought this year. With a foreign debt of nearly $6 billion and a debt service ratio exceeding 25 percent, Tunis will have to cover new financial needs by making hard choices between development priorities, taxation, and lower domestic consumption. Moreover, Tunisia's financial troubles may be aggravated by Prime Minister Mzali's move to replace the governor of the Central Bank because his pessimistic economic reports reduced President Bourguiba to tears, according to the US Embassy. [redacted]

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International Trade

Foreign Views on Including Investment Issues in the GATT

According to US Embassy reporting, many nations support the principle of including investment issues in the GATT, but differ over which matters should be addressed. To date, the most positive support has come from the governments of France, Japan, Spain, Switzerland, and Togo. Of the OECD countries expressing reservations, most fear strong LDC resistance and overloading the GATT agenda. A member of the West German Government said that most EC members believe the US proposals go too far, too quickly, and cannot win acceptance by the LDCs. Most governments believe the LDCs will be particularly opposed to inclusion of investment if topics such as right of establishment and expropriation are included. Moreover, Bonn and London are concerned that hostile LDC reaction toward including investment will adversely affect new round negotiations covering services issues. LDC reaction has been mixed. The traditional hardliners—Argentina, Brazil, India, Yugoslavia, and Egypt—opposed the US position at last week's GATT preparatory meetings. Most of the developing countries, however, are studying the issue and waiting for other LDC reaction before taking firm positions.

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Foreign Views on US Initiative To Include Investment Issues in the GATT

Supports/Agrees With US Position	***Agrees in Principle***	***No Objection/ Possible Support***
France	European Community	Canada
Japan	Italy	Finland
Spain	New Zealand	Indonesia
Switzerland	West Germany	Thailand
Togo	Norway	South Korea
	Sweden	Tunisia
		Ghana
		Uruguay

Noncommittal	***Opposes US Position***
Australia	Argentina
Denmark	Brazil
Iceland	India
United Kingdom	Egypt
Malaysia	Yugoslavia
Pakistan	Cuba
Singapore	Colombia

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Global and Regional Developments

More Libyan Aid for Sudan

Libya is providing new military materiel and support to Sudan and may provide additional amounts of economic assistance. The US Embassy in Khartoum says, on the basis of a variety of sources, that Libya has moved as many as 300 trucks filled with food and military supplies to western Sudan to aid government efforts to dislodge rebel forces. In addition, the US Embassy says Tripoli probably will supply up to 100,000 metric tons of crude oil this year, although the terms of the agreement have yet to be settled. Unlike the 300,000 tons of free oil Libya supplied last year, the new oil may be in barter for Sudanese goods and services. In return for this largesse Qadhafi probably will demand that Khartoum distance itself further from the United States and Egypt to keep aid deliveries on track, and may ask for Sudanese support for Libya's position in Chad.

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National Developments

Developed Countries

Ottawa's Banking Proposal Criticized

Ottawa is planning to designate Montreal and Vancouver as international banking centers. The proposal, as it currently stands, would exempt banks in these cities from a number of taxes, including provincial capital taxes and those on international transactions, as a means of attracting more international banking activity and hence more jobs. The plan has been criticized by financial analysts and the banks, however, as providing little incentive for the banks to repatriate their overseas operations because it neglects to reduce Canada's relatively high withholding tax. Ottawa continues to reject the tax concessions sought by the financial community because such action would reduce tax revenue when the government is trying to reduce the budget deficit. As a result, critics claim the proposal is a crude attempt by Ottawa to boost its domestic support in Quebec and British Columbia by lessening Toronto's dominance of Canada's financial activity.

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Probable Japanese Pump-Priming Measures

The economic stimulus package Tokyo plans to announce before Prime Minister Nakasone's US visit in mid-April will do little to boost an economy hard hit by the yen's recent upsurge. Large tax cuts and a sharp rise in government spending are not seriously being considered because most economic policymakers, including Nakasone, remain committed to budget austerity. Instead, Tokyo is likely to announce a package that includes accelerated public works expenditures, reduction in utility rates, a further discount rate cut, and additional relief for small exporters hurt by the strong yen. Plans to disburse 80 percent of fiscal 1986 public works spending in the first half of the year will add little stimulus—70 percent is the normal practice. Expected reductions in utility rates—less than $2 a month per household—will do little to spur consumer spending. Previously discussed modest cuts in income tax rates have been shelved, according to the US Embassy, but may come up again before this summer's elections.

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London Moving To Ease Monetary Policy

Chancellor of the Exchequer Lawson, in his budget speech last week, reaffirmed London's committment to a "sound" monetary policy, but there are signs that there will be some easing in the coming months. Lawson reinstated sterling M3 as a monetary tool and said that the 1986-87 higher target range of 11 to 15 percent is still consistent with an anti-inflation policy. London had dropped the sterling M3 measure last year after it exceeded the 5- to 9-percent growth target and as a result of complaints in financial markets that M3 was an unreliable indicator of monetary conditions. As another sign of easier credit, the Bank of England lowered its money market intervention rate the day after the budget speech. This permitted commercial banks to lower base lending rates by 1 percentage point to 11.5 percent. We believe London will be able to ease its monetary policy further over the next several months because inflation is expected to fall from 5.5 percent to 4 percent this year, and sterling has strengthened against the dollar and the deutschemark since the United States, West Germany, and Japan lowered their discount rates.

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New French Economic Team

Prime Minister Chirac has pledged to press for swift economic reform—especially denationalization—during his first months in office, and Chirac's cabinet underscores the importance he attaches to economic issues. While President Mitterrand pressed hard to influence ministerial appointments in foreign affairs and defense, Chirac managed to handpick his economic team. Chirac named Edouard Balladur, his longtime confidant and top political aide, Minister of State for Economy, Finance, and Privatization. As head of what the press has termed France's "superministry," Balladur is likely to emerge as the most important cabinet member after Chirac. Although his experience in economic affairs has been limited, US diplomats consider Balladur an extremely competent moderate who is committed to a free market approach. Alain Juppe, junior minister in charge of the budget, is perhaps Chirac's most trusted economic adviser, and has repeatedly called for simultaneous tax and budget cuts. Chirac installed another member of his neo-Gaullist party, Michel Noir, as junior minister for trade. Minister of Agriculture Francois Guillaume is head of the most powerful French farmers' union and can be expected to fight vigorously to protect French and EC farmers. In his first public statements he warned that the Community must be prepared for an agricultural trade war with the United States to protect its export markets.

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Stronger-Than-Expected West German GNP

Stronger-than-expected gains in private consumption should propel real GNP growth into the 4-percent range this year—a big bonus for the Bonn coalition's reelection prospects. Real disposable income will be boosted by nominal wage gains between 3.5 and 4.5 percent, combined with inflation of about 1 percent. Already low West German inflation is improving because of the weak dollar and falling oil prices. Also adding to purchasing power will be this year's DM11 billion tax cut, new family income supplements, and as many as 400,000 new jobs.

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Italy Lowers Discount Rate

On 21 March, Treasury Minister Goria lowered Italy's official discount rate by 1 percentage point to 14 percent, but this is not likely to have much impact on real interest rates, currently 7 to 9 percent. Goria announced that the move, which follows similar reductions in other industrialized nations, was made possible by declining domestic inflation, a recent increase in the Bank of Italy's reserves, and the favorable impact of falling oil prices. The market, however, probably will not respond quickly to Treasury's signal. Difficulty in marketing treasury securities, which forced Rome to raise rates on three- and six-month treasury bills in January, persists and will keep those interest rates high. According to the Italian Bankers Association, commercial banks are reluctant to decrease their rates because of credit and foreign exchange restrictions imposed in conjunction with January's treasury rate hikes. Moreover, neither the Treasury nor the Bank of Italy appears willing to remove the ceiling on bank loan growth in the near future.

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Turkish Response to Foreign Exchange Difficulties

Speculation in Turkey's foreign exchange markets and a shortage of foreign exchange prompted Ankara to devalue the lira by 5.2 percent against the dollar on 14 March and retreat from plans for further liberalization of foreign currency regulations. The Central Bank has set the band within which commercial banks trade foreign exchange at plus or minus 1 percent of its official exchange rate, putting an end to the unrestricted trading permitted since last July. The bank said free market operations would resume as soon as possible. Ankara also asked the United States in February to disburse the remaining $19.6 million in fiscal year 1986 ESF aid early because of a serious foreign exchange shortage. Following expiration of grace periods on previously

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rescheduled debt, debt service jumped by one-fourth to an estimated $3.7 billion in 1985, equal to approximately 28 percent of foreign exchange earnings. In addition, Turkey's foreign exchange position has been strained by Ankara's decision to buy oil on the spot market while it tries to renegotiate expensive barter contracts with Iran and Libya. Moreover, Iraqi arrearages on $800 million in Turkish export credits extended since 1983 may be aggravating the situation. [redacted] 25X1

Less Developed Countries

Guatemalan Economic Program Announced

[redacted]

President Cerezo's economic program contains several positive steps to revitalize the economy but, on balance, is unlikely to reduce the budget deficit, decrease inflation, or restore business confidence. Without formally changing the official exchange rate, the program shifts most commodity imports and 25X1 exports to a new "regulated" exchange at a rate close to the former parallel market and includes a more flexible rate for most services. Debt service payments will continue at the official rate. The package calls for a 5-percent cut in public spending and higher luxury and export taxes. Nevertheless, it also grants a public-sector wage increase and promises creation of 40,000 temporary public jobs. Price controls were retained on 25 consumer good categories. Subsidies for public transportation and imported medicines also will continue. [redacted] 25X1 The measures are unlikely to satisfy 25X1 international creditors and will make it difficult for Cerezo to negotiate the new lending he is counting on. [redacted] 25X1

Algerian Belt-Tightening

[redacted]

Algeria, facing up to a 50-percent drop in its hydrocarbons earnings this year, has begun implementing austerity measures. So far, the Bendjedid government has cut tourist overseas travel allocations in half and reduced allowances for the annual pilgrimage to Mecca. Efforts are also under way to cut nonessential 25X1 imports and postpone development projects. In addition, Algiers is making plans to borrow heavily on the international market. Embassy reporting indicates Algeria is seeking a $500 million loan, but Algiers' insistence on easy terms could thwart the effort. Any political backlash from harsh adjustment measures will probably be limited largely because the government has been preparing the populace for some time for economic hard times ahead. Moreover, Algiers has shown the will to use its extensive security forces in dealing decisively with local disturbances. [redacted] 25X1

Saudis Delay Budget

[redacted]

King Fahd recently surprised most government ministers and the Saudi business community by postponing for at least 5 months a new budget for the fiscal year that began 11 March. The delay puts off tough decisions on further 25X1 spending cuts and allows monthly spending to continue at last year's level. Last year, spending was reduced 8 percent and started to have a direct impact on

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Saudi citizens, but this failed to balance the budget because oil earnings—about two-thirds of government revenue—fell rapidly. [redacted] 25X1

[redacted] 25X1

Omani Spending Cuts

[redacted]

The Omani Government has cut spending in its 1986 budget because of sharply lower oil earnings. An early casualty is the purchase of 8 Tornado fighter aircraft from the United Kingdom—delaying the purchase until 1992 effectively cancels the deal. Defense spending overall has been cut 25 percent from 1985 levels. In addition, most new development projects have been halted. [redacted] 25X1

[redacted] 25X1 25X1

[redacted] 25X1

More Indonesian Budget Woes

[redacted]

According to US Embassy reporting, the continued fall in oil prices may soon force an additional $1.8 billion in budget cuts—including $1.3 billion in project reductions—over those proposed last January. The new cuts occur at a time when the Indonesian economy is in a tailspin. [redacted] the economy is expected to contract by 4 to 5 percent in 1986, and there is growing sentiment for government deficit spending to spur economic activity. So far Jakarta has resisted such moves for fear of touching off a new round of inflation. In addition, the government is afraid that any rise in interest rates would "crowd out" the private sector in Indonesia's thin capital markets. Jakarta continues to pin its near-term economic hopes on an expansion of the nonoil sector, but is moving slowly on basic economic reforms to encourage exports. For example, at the same time the Finance Ministry was denying rumors earlier this month that foreign exchange controls were being contemplated, the Trade Ministry was imposing more import restrictions. [redacted] 25X1 25X1 25X1

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Philippines Lifts Copra Export Ban

In our judgment, the Aquino government's lifting this week of a ban on the export of copra—the oil-bearing meat of a coconut—should improve the economic situation in the countryside, where one-third of the population relies on coconuts as its primary source of income. The export ban, imposed in 1982, 25X1 resulted in low domestic copra prices because farmers were forced to sell to a small number of domestic coconut oil mills controlled by a close Marcos associate. We estimate that copra prices will increase by at least 50 percent over the next several months as oil mills and exporters will now compete for domestic copra. The chairman of the government's Coconut Authority has warned, however, that the ban could be reimposed if domestic mills encounter a shortage of copra. 25X1

Malaysia Planning for Slower Growth

Details of the Fifth Malaysia Plan—covering 1986-90—which was released this week, projects slower growth than during the past five years, rising unemployment, and increasing reliance on the private sector for investment funding. The new plan envisions average annual real GDP growth of 5 percent 25X1 through 1990 and unemployment rising to 10.1 percent. With projected growth now at 3 percent for 1986 and little improvement likely in the next two years, growth over the final two years of this period would have to exceed 7 percent annually for the plan to succeed. We believe that the plan implies further backpedaling on improving economic opportunity for ethnic Malays under the New Economic Policy, which will have an adverse effect on the government's prospects in elections widely expected within the next few months. 25X1

Communist

China Unveils New Five-Year Plan

Premier Zhao Ziyang presented a draft of China's Seventh Five-Year Plan (1986-90) for discussion during the annual National People's Congress. The document calls for further reform of the Chinese economy, including limiting the number of products under state control and making more enterprises 25X1 economically independent entities. The plan also is aimed at slowing and consolidating economic growth during the period, but Zhao acknowledged that the target of 7.5-percent average annual growth in GNP is likely to be exceeded. 25X1

China Considers National Pension Plan

The Ministry of Labor has announced that it is considering a national pension plan for retired workers. The proposed plan would require each enterprise to contribute a specific percentage of its payroll to a national fund, rather than being solely responsible for its own retirees as is currently the case. The 25X1 ministry cites the new plan, implemented in trial areas early last year, as being more equitable and particularly helpful for older enterprises with a large number of retirees. We believe the system is also being considered as part of plans to allow individual firms more economic independence, including the possibility of failure and dissolution under the bankruptcy laws currently being drafted. 25X1

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